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Warburg, Paul Moritz

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Paul M. Warburg...

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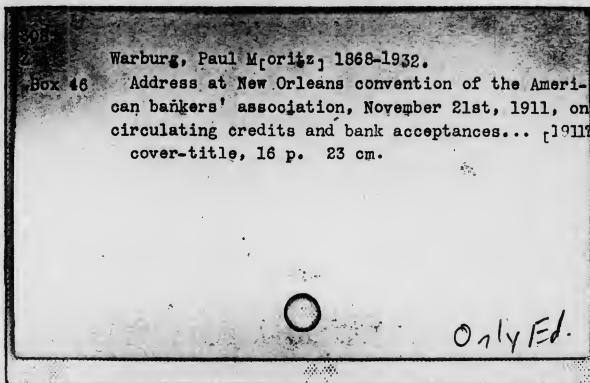
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Address Made by Paul M. Warburg

at New Orleans Convention of the American Bankers' Association

NOVEMBER 21st, 1911

on

Circulating Credits and Bank Acceptances

Sent with the compliments of George H. Paine, Philadelphia, Pa.

For the benefit of those who do not know Mr. Warburg, I quote from Holland, who writes:

"He (Mr. Warburg) is one of the foremost experts in the world upon the subject of foreign exchange, and his knowledge of the principles upon which banking is conducted is not exceeded by that of any other banker."

And again from a world-wide known banker, who says:

"Mr. Warburg, as a banker, has no superior in this country."

AMERICAN BANKERS' ASSOCIATION

NEW ORLEANS CONVENTION.

CIRCULATING CREDITS AND BANK ACCEPTANCES

By Paul M. Warburg, of Kuhn, Loeb & Co., New York City.

In studying and teaching ancient history we lay great stress upon the names of kings and dates of battles, while we unduly neglect the more important problem of how the people lived and what were their thoughts and ambitions. It is in considering this phase of history that we perceive most clearly the development of man and the progress of intellectual development, a process as yet by no means completed.

In dwelling upon such thoughts one cannot help recognizing as one of the most striking differences between primitive man and ourselves that in the daily routine our ancestors took very little for granted, that everything they used and every manipulation they performed they understood and did from beginning to end. In short, they were dependent entirely upon themselves. On the other hand, there is hardly anything in our daily routine that we use, or do, or even understand, from beginning to end. The activities of one day, even with the least developed of our fellow creatures, are indissolubly interwoven with those of millions of fellow beings whose products we eat or wear or use, and the most surprising feature of this evolution is that we have become quite unconscious of it.

Riding in the subway in the morning, while reading our paper, do we think of the men that broke the coal, built the power-house, car and track, and that operate them at the very hour? Do we think of the thousand manipulations and inventions that produced our newspaper, and of the hands that wrote, printed and distributed it? Do we while we are reading think at all that we are riding at the rate of sixty miles an hour? Does the tenant of an office on the thirtieth floor think of the thousands of devices that had to be invented and applied to make the "sky-

scraper" safe and practicable? Does he stop to consider what would happen to him if the house were not fireproof, or if he could not rely on the elevators or his telephone?

We have become accustomed to rely so completely on the perfection of all these appliances and the normal functioning of the thousands of hands that co-operate in serving us during the day that unless there be a sudden stop of a wheel we use them without further thought. To this class of appliances, that it takes millions to compose and ages to develop, and that we use without thinking, belongs the thing so important to us all, the thing commonly called "money."

In a modern system we can no longer separate actual money from the many appliances that take its place in our daily routine; they are linked together and have all become essential parts of one big machinery.

The modern banking system has been likened to a huge skyscraper based on a comparatively small foundation of gold, and the many superimposed stories are represented by the immense number of all obligations payable in gold which, ordinarily, are settled by clearings of credits.

The most evident and direct forms of circulating credits which have taken the place of actual gold are the bank note—forming a class by itself—and bank deposits and checks. These are the main tenants of the towering structure. But they in turn have sublet a great many floors to all the other appliances for clearing indebtedness, all of which in the final analysis are being reduced to payments by exchange of bank credits.

Time will not allow to deal fully with the interrelation and the functions of all these tenants of the building; we shall only casually mention the most important phases.

A modern system aims at establishing standard values for which a broad market can be created, so that assets can be quickly turned into bank credits. This is one of the most fundamental principles of modern banking, of equal portent for depositor and banker. Our most important staples are no longer dealt in in individual lots, which must be personally examined before the bargain can be struck, but they have been standardized and spe-

cial exchanges have been organized in order to reduce merchandises into bank credits in the quickest way and to offset all purchases and sales so as to reduce to the minimum the actual use of money.

We have achieved the same perfection in dealing with stocks and bonds. While the original part ownership in a business could be transferred only by protracted negotiation and by finding a new purchaser who, after full examination, would take the place of the old owner, evolution has brought about the corporation, issuing stocks and bonds in easily transferable shape, so that these forms of investments and indebtedness have also been mobilized. They, too, have been developed into securities for which large special markets and organizations have been created, enabling the owner to transform his holdings with the greatest possible dispatch into bank deposits. In this respect stocks and bonds have become circulating credits, they are the means of transferring part ownership in, or the indebtedness of, a corporation from the owner to another in quick succession. But while the bank note and the check are clearers of credits on demand, stock and bond transactions are clearers of credits on time, or even for an indefinite period. They are only indirect and secondary.

The most important of the subtenants is the commercial paper. In a modern system the promissory note, running for a limited number of months and representing some kind of a commercial transaction, has been mobilized by adding to it, by indorsement on the back, or by acceptance on the face, the banker's guarantee. Thus the old-fashioned "bill"—existing already in the form of bricks in the age of Hamurabi—is being transformed into a "bill of exchange," thus an immovable investment is turned into a quick asset. The importance of this evolution is twofold, because it is just as fundamental for the safety of the individual bank as it is for that of the whole credit banking system. The main assets of a deposit institution ought not to be stocks and bonds, nor loans on stocks and bonds, but commercial paper. But a bank, the deposits of which may be withdrawn on demand at any time, must have assets which can be reduced to

bank credits within the quickest possible time and with the smallest possible loss, if any.

If a banking system like ours is built up on promissory notes which have no free market, the consequence must needs be that when deposits are withdrawn heavily, or when there is a strong commercial demand for money, stock exchange loans must be called and holdings of securities must be sacrificed, these being the only available liquid assets. This means great economic waste and often calamity, for it is an absolutely perverse system that expects a *normal* investment demand, in times, especially when money is scarce, to be able to supply a sufficient sum to satisfy all the immense commercial demands of the entire nation. Moreover, it follows that prices of securities have to be so far reduced that at bargain, or sometimes panic prices, an *abnormal* demand for securities at home or abroad will be stimulated. This method is not only wasteful, but, as the past has shown us, it is most dangerous. A modern system must provide the means which banks can rely upon to enable them to market their bills receivable, which represent the trade and commerce of the nation. In a modern system this can be done without appalling losses, there being no question of sacrifice of capital in selling securities, but only a question of difference in rate of interest in selling paper. Moreover, it can be done without creating a panic; since gradual liquidation of commercial paper means a reduction of the volume of all commerce and trade, which is adjusted by co-operation of every toiler and consumer. It is thus spread over 100 million people instead of falling back on the holders of stock exchange loans and investors, few in number by comparison. While our system has remained entirely archaic and primitive in this respect, Europe enjoys the full advantages of a highly developed discount system, which averts panics there with as much certainty as we may expect their occurrence with us.

Commercial paper and bank acceptances form the main asset of European banks. These bills have the widest possible market, where millions are exchanged daily with margins of $\frac{1}{16}$ per cent. or $\frac{1}{8}$ per cent. in the interest rate without the necessity of scrutinizing the paper when the bargain is struck. Bills of ex-

change have been standardized, everybody in all parts of the globe knows what names of the many thousand that appear as endorsers and acceptors are considered as "good delivery," and everybody knows against which names is discrimination. The daily differences are normally regulated in the case of European banks by means of larger sales of bills receivable or by larger investment in these bills.

The mobilization of the promissory note, the system which enables Europe to transform bills into bank credits as quickly as staples or securities, is the explanation of Europe's success where we have failed.

To insure safety for such a discount system, however, to render it possible and effective, a central reservoir for all the cash of the nation is necessary, as, inversely, for the safety and efficiency of the central reservoir a system of exchanging bills is a prerequisite.

If a system constructed upon credit is to be safe, the first condition is that cash must be less valuable or attractive than the bank credit.

Holding of cash entails the risk of loss or robbery; it is a source of danger, like ammunition which we keep under our roof. Moreover, to keep cash unemployed means a loss of interest; depositor and bank alike must therefore try to turn cash holdings into interest-bearing bank credits with the greatest despatch and to the largest degree that may be possible and permissible. This alone will allow cash at all times to return freely and rapidly into a central reservoir as provided by modern financial systems; this alone will allow the central organization to respond freely to any demand for cash, because the latter cannot fail to return through some other channel, unless it be taken for export.

But in order to secure the free flow of cash into a central reservoir it is a prerequisite that there must be absolute confidence (1) that there is enough cash to meet all emergencies, (2) that it will be freely forthcoming when demanded, and, last and most important of all, that the banks must be sure that they may be able, in case of need, to build up with such central organization a cash credit upon the strength of which they can withdraw cash, if such may be required from them. It follows then that under a

modern system there are two entirely different duties to be performed by the general banking institutions and the central organ. The former must see to it that they can command cash credits to meet their demand obligations, but it is the duty of the central reservoir to see to it that these cash credits be always transformed into actual cash when required.

The means, however, by which banks transform their assets into cash credits with the central organization are the rediscount of bills purchased, local or foreign. Commercial paper, transformed into bills of exchange easily marketable at all times, forms the means of connection between the central organ and the banks; it constitutes the elevator system of the sky-scraper, which alone renders the ever-growing tower safe and habitable.

This division of functions and this means of connection between the central institution and the individual banks cannot be too clearly understood:

In Europe the general banks have no cash reserves, they have credit reserves. The duty to transform credit into cash resting on the central organ, it alone is concerned in the holding of adequate gold reserves and in watching that a certain and safe proportion be preserved between the aggregate demand obligation of the nation and its holding of gold. The existence of such a strong supervisory organ and its ability to maintain the nation's credit creates that safety for the circulating credits of the nation which renders the whole system possible. For it is the confidence in these circulating credits which creates the broad market for money, always flowing where it can earn interest in safety, and it is in turn this free flow of money, attracted or driven away by a higher or lower rate of interest, which protects the central organ. By increasing or decreasing its rate of interest, thus taking a larger or smaller part in the nation's investments in commercial paper by accumulating or selling holdings of foreign bills of exchange, the central organ exercises a regulative influence which keeps it strong enough to protect each bank individually in case of need, thereby safeguarding the whole nation.

"Safety," from the point of view of banking investments, consists of two elements: the one, the intrinsic value; the other, its market. A consideration of these two factors produces the

stipulation of the interest return that the investment must produce.

International money may flow to England and buy three months' British bank acceptances at $2\frac{1}{16}$ per cent., while for three months' English time money it would possibly demand $3\frac{1}{2}$ per cent.; the difference between the two rates showing the difference in value between a quick asset and an investment for a definite period. But even a comparative rate of 4 and 5 per cent. could not cause international money to invest largely in American commercial paper; since not only is it an unsalable, unliquid investment, but it has not been standardized. It is individual and provincial in its character, while the American banks which, knowing the maker of the note, might render it liquid and salable abroad, must not, under present conditions, freely endorse or accept it. Moreover, as long as is lacking with us, a central organ that would guarantee its market in case of need and secure at all hazards the transformation of cash credit into cash, foreign money will remain cautious and the interest inducement must remain comparatively exorbitant.

Contemporaneous financial history furnishes us constantly with illustrations showing the superiority of the European system. We have not only lived through the disgraceful collapse of our own machinery, but quite recently again we have seen the advantages of European financial methods. During the recent Morocco crisis a war scare developed in France and actual hoarding of gold began; the withdrawals from the deposit banks were at a given moment alarming. But there followed no panic. The Banque de France issued notes freely, the French banks collected their holdings of foreign paper and the general confidence in the Banque de France's power to cope with the situation overcame the fright without the calamities that would have ensued with us.

When France, for reasons just explained and as a means of political pressure, withdrew from Germany more than 200 million marks that temporarily had been invested there, when English and Russian money was called back, when runs began upon savings banks, Germany had to face a very severe strain. But

what happened? The German Reichsbank rapidly increased its credit facilities by about \$150,000,000; moreover, it had accumulated in times of ease vast sums of foreign bills, and when rates of exchange moved up to a point warranting gold exports it began to sell these foreign holdings. At the same time a comparatively slight increase in its rate took place, which brought new money, mainly American, to Germany's assistance. This inflow of foreign money was increased by the sale abroad of German treasury notes.

What would have become of Germany without the Reichsbank?

Without the confident reliance that the Reichsbank would be able to meet the situation and without its ability to apply all these various means of defense, general suspension would have been inevitable. It is the elasticity of such a system that renders it safe, and it is the implicit confidence that it inspires that made our bankers send their money, without hesitation, in spite of a critical situation, in order to secure for a few months a beggarly $\frac{1}{4}$ per cent. to $\frac{1}{2}$ per cent. interest per annum more than they could have obtained at home. We had no war scare, the country was full of gold in 1907, but rates of 50 per cent. to 100 per cent. could not bring money, because our system—or rather the lack of system—had killed our own confidence in our own credit. We have no credit system, but a discredit system.

The advantage of a big central organ, not run for profit like the general banks, but administered solely for the protection and safety of the nation, is plainly shown by Germany's recent history. The complete withdrawal of money from "gainful occupation," turning it into idle cash to serve as means of legitimate assistance in times of need (a real and effective reserve in that respect, not a nominal one like our ineffective idle funds, which are termed reserves by a misnomer); the quiet accumulation of foreign bills—less profitable than the German bill carrying a higher rate of interest—could only be brought about and brought into effect by such an institution.

It is the inefficiency and the discredit of our system which severely handicaps us also in our foreign trade; for a foreign

purchaser will rather buy merchandise to be paid for in sterling than in dollars, and for the shipping of goods purchased abroad, be it South America or Asia, the American merchant has to provide European bank acceptances, because the acceptance of the American banker, no matter how good his credit, has no market. We pay an annual tribute of millions to Europe for the financing of our trade, which is not only a wilful national waste, but also a blemish on our financial standing.

A wonderful change will take place in all these respects if the bill now in preparation by the Monetary Commission will be passed on the lines as suggested by Senator Aldrich.

Without creating a central bank—for all the far-reaching banking powers have been eliminated which are characteristic of European central banks—and without fundamentally disturbing existing banking methods, merely by a simple device of federating the now scattered reserves into one general reservoir to be jointly administered for the protection of all, our system will be changed from a provincial, old-fashioned, wasteful and dangerous one into a national, modern, economic and safe structure.

Our system—at present a tottering, top-heavy sky-scraper without a solid foundation, the tenants, instead of uniting in constructing a safe substructure, having solely concentrated their efforts on strengthening and fortifying each his own flat—a towering fire-trap provided with an old-fashioned staircase as the only means of communication for all its disconnected tenants, with one stroke becomes modern and safe. Or as I said on previous occasions, the 20,000 to 30,000 scattered pails of water, representing our disconnected bank reserves, will be united into one large reservoir, with a system of pipes leading to every house, bringing safety to all by co-operation.

While the solution is simple in principle, it had to be complicated in form; for it had to satisfy even the most suspicious mind that control and abuse of power by individuals, singly or combined, political or financial, would be absolutely impossible, and it had to take into consideration that a modern discount system cannot be created by a stroke of the pen and that therefore a new device had to be invented to bring about a safe and ef-

fective mobilization of the present form of American commercial paper.

Both will be achieved under Mr. Aldrich's plan.

It is true that we shall have to create a machinery more cumbersome in operation and not quite as far reaching in effect as the European systems, but a careful consideration of all the details convinces the student that a simpler way would not be a safe one.

The plan if carried out on its present lines will by process of federation bring about a centralization of reserves with a guarantee of decentralization of banking facilities. It will strengthen the independence of the smaller banks, and while restricting the National Reserve Association to the smallest possible field of operations, the power given to this Association will be large enough to protect the nation in the future. It will bring about the mobilization of our commercial paper, and in encouraging bank acceptances it will help us to finance our own trade and to establish in doing so the first basis for the development of an American discount market, a step of the greatest importance for the future of our country. The National Reserve Association will be able to accumulate foreign exchange, and thus to act as a protector of the nation in times of need. It is also to be hoped that some way may be found to enable it from the beginning to meet emergencies by being in a position to sell short treasury bills of the United States.

The National Reserve Association, if enacted into law, will take the monetary system of the United States out of Wall Street, and instead of a rigid system, the little elasticity of which is now based on stocks and bonds, we shall enjoy an elastic system primarily based on commercial paper, bank acceptances and foreign bills.

I have almost concluded my address without dealing with the bank notes, which, as circulating credits—the subject matter allotted to me—ought to have been treated prominently. In beginning to study the subject of monetary reform one is apt to think that the question of note issue is the primary one. After some years of struggling with this problem one learns to under-

stand that the question of effective reserves and liquid credits is the main question and that note issue is only a secondary phase and of lesser importance.

If any bank rediscounting with the Bank of England, Reichsbank or National Reserve Association may take gold against its credit balance, there is, from the National Reserve Association's point of view, no difference between this balance and a bank note against the presentation of which gold may be demanded. Bank notes are deposits in bearer form. The liability for bank notes and deposits is the same. For each deposit can be turned into bank notes, and each bank note into a deposit, and inversely, and for the same reason, it is immaterial whether a general bank owns a bank note or a credit balance with the Bank of England, the Reichsbank, the Banque de France or the National Reserve Association.

[FOOTNOTE.—Mr. Aldrich has very wisely, and I believe for the first time in banking history, made the liability a subject of measure and taxation—not alone the note issue, as in France and Germany. To my mind the law would be even more perfect if the clauses taxing the note issue were left out entirely. In France and Germany, where an effective check system does not yet exist, note issue is the barometer of expansion, while with us and in England deposits play the more important part.]

Some of our leading financial papers appear not to have fully grasped this point. Because National banks are not allowed to count their own notes as reserves, it is argued that also the notes of the National Reserve Association should not be counted as reserves. But the difference is obvious. The National Reserve Association could not count its own notes as cash; returning notes will not be treated as an asset, but be charged off reducing liabilities. In order to avoid confusion, our present National Bank Notes must be considered collectively in this connection. From that point of view National Banks must treat their own notes, like checks on other banks, as clearing values; as assets but not as cash. The notes of the National Reserve Association are liabilities of an independent institution endowed with a huge capital and organized for the sole purpose of pro-

viding for the payment in gold of all its liabilities, including its notes. If the balance with such a National Reserve Association is to be counted as cash, as it should be, the note certainly must be counted as cash, too.

When one of our leading financial weeklies advanced the argument that such notes should not be counted as reserves because they are not so counted in Europe it went far afield. For as we have seen, in none of the leading European countries is there any law requiring general banks to keep cash reserves, nor do the banks generally keep more cash than they actually need for their daily business. Neither would it strengthen the general system if they accumulated gold reserves. Quite the contrary, it would interfere with the free flow of gold into the central reserve where, becoming the basis of an elastic system, it can do vastly more for the efficiency and safety of the whole system than if locked away in a single bank. Since we possessed no central organ for the consolidation of our reserves, we had to have laws requiring each bank to accumulate reserves of its own. This archaic and unfortunate method can, however, now be turned to good account. For this direct co-operation in strengthening the reserves of the National Reserve Association—which co-operation in this form and to this degree does not exist in Europe—is all the more necessary since, through the lack of a highly organized discount system and through the restrictions placed upon the scope of its operations, the National Reserve Association would otherwise not command the strength and the confidence enjoyed by European central banks. In other words, with us the elevator service being less perfect—in the beginning at least—the foundation must be so much broader.

The fear that notes counted as reserves would attenuate the basis on which our banking system rests would apply with equal force to balances kept with the National Reserve Association which, under the new plan, may be counted as reserves. This possibility of attenuation is the very element of elasticity.

It is the function of the National Reserve Association to see to it that all its liabilities—balances and notes alike—are fully protected by an ample supply of gold and by a credit so strong that nothing can shake it. A system without the power to ex-

pand, no matter how large its gold holding, remains vulnerable. Elasticity wisely safeguarded—as in this plan—is the basis of confidence and therefore of safety.

Not infrequently one hears the question: If it be true that the National Reserve Association will democratize our system and to a large extent turn the bank's call money into the bill market, taking it away from Wall Street, why should the latter favor the new law?

The answer is plain: This overflow of money, which in times of ease floods New York and which when needed is withdrawn with such vehemence that it causes violent convulsions, is a constant source of danger to that city. While our present system makes New York the undoubted money center and gives to its banks a position of pre-eminence and predominance, this power is possessed only at the expense of a responsibility which, with our present system, in times of stress brings mortification and humiliation. Wall Street, at present, is a ruler on a keg of dynamite. And like many an absolute ruler in recent years, it finds it more conducive to safety and contentment to forego some of its prerogatives thrust upon New York, not by its own will, but as a result of our present laws and conditions, and to turn an oligarchy into a constitutional democratic federation.

But that is not all. We are a nation still in its formative period, full of ideals and ambitious imagination. It is not the hunt for the almighty dollar that prompts men possessed of millions to keep on toiling and struggling with nature and with their fellow creatures; it is the youthful and boundless energy craving for constructive success, the joy of creating and the conscious and unconscious desire of taking a hand in the triumphal development of this great country. Our ambitions are great and it hurts our pride that, while we have become powerful and leaders in many respects, we are an object of contempt and of ridicule when it comes to the question of our monetary system. We cannot become a center of international finance on a par with European countries until we reorganize. If New York has to make some sacrifice in order to achieve this aim she is willing to do her share, just as every part of the country will

have to contribute. Whatever little advantage may be lost in the beginning, the safety and continuity that will be ours will return in many other ways. The United States enjoying a modern financial system will attain that place amongst the nations which should be hers by destiny, and she will weather in safety and dignity the storms, from within and without, that may be in store for her. A modern financial system will enable the banks fully and safely to finance the future growth of this country, and *vice versa*, a healthy growth of the country is bound to bring prosperity to the banks. The "sky-scraper" placed on a solid foundation will safely carry many additional stories and the tenants will be at once secure and prosperous.

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